Testimony of

GAVIN M. GEE

DIRECTOR OF FINANCE

For the

STATE OF IDAHO

on behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

before the

FINANCIAL SERVICES SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

UNITED STATES HOUSE OF REPRESENTATIVES

March 27, 2003

Good morning Chairman Bachus, Representative Sanders and members of the Subcommittee. I am Gavin Gee, Idaho Director of Finance, and Chairman of the Conference of State Bank Supervisors (CSBS). Thank you for asking us to be here today to share the views of CSBS on regulatory burden reduction and the "Financial Services Regulatory Relief Act of 2003." I would also like to thank Representative Capito for her sponsorship of this thoughtful legislation.

CSBS is the professional association of state officials who charter, regulate and supervise the nation's over 6,000 state-chartered commercial and savings banks, and more than 400 state-licensed foreign banking offices nationwide.

We applaud your commitment and efforts to reduce the burdens imposed by unnecessary or duplicative regulations that do not advance the safety and soundness of our nation's financial institutions. This committee deserves special recognition for its efforts to remove these federal regulatory burdens, allowing our banks to compete with other financial entities at home and around the world. This competition encourages efficiency and innovation, benefiting the economy and consumers alike.

The most important contribution toward reducing regulatory burden, however, may be empowering the state banking system. State banks and the flexibility of the state system have created the vast majority of innovations in banking products, services and business structures. CSBS greatly appreciates the commitment of the Congress to preserve and enhance the ability of the states to respond to customer and business needs. Support of dual federal and state chartering will allow our financial markets to continue to be the world's most vigorous.

Choice in the regulatory environment can have many of the same benefits that it has in the business environment. Knowing that banks have a choice, regulators work smarter and more effectively. The safety and soundness of the financial institutions we regulate is our goal, and it is essential that we have the necessary resources to ensure a healthy banking system. Without the existence of a parallel regulatory system, however, an expensive, inefficient and monolithic regulatory regime could easily develop that would burden and restrict financial institutions, disadvantage them in the marketplace, and create a less healthy banking system. As our founding fathers recognized, we need federalism, not just the federal apparatus, in our banking system.

Through innovation, coordination, and the dynamic use of technology, states have made great strides in reducing regulatory burden for the institutions we supervise. As Congress considers new regulatory burden relief measures, we ask you to ensure that we can continue to pursue these efforts. We also ask you to consider initiatives that will provide equal competitive opportunities for state-regulated and federally-chartered institutions, and that will clarify the interaction of state and federal law and the ability of state governments to protect their citizens.

Innovating to Reduce Regulatory Burden

The state banking departments have always sought to measure each regulatory requirement against its benefit to the public. In supervising state-chartered institutions, we have seen how the cumulative burden of regulatory requirements can have a detrimental effect on the public by diverting banks' resources from lending and other financial services to regulatory compliance.

Over the past few years the states, independently and in conjunction with their federal counterparts, have focused their efforts on reducing the burdens on state-chartered institutions. They have done this by streamlining regulatory procedures, rescinding unnecessary regulations, embracing technology to improve the examination process, and working together to assure the strength and survival of the state banking system.

Let me briefly mention a few examples.

In addition to robust on-site, risk-focused examination procedures, **46** states have implemented off-site supervisory surveillance monitoring programs. These programs are designed to complement onsite analysis. Off-site surveillance allows regulators to monitor the overall condition of banks between examinations and thereby provides additional tools to promote safety and soundness above and beyond point-in-time examinations. Off-site surveillance also helps regulators plan for the scope (what issues examiners should focus on) before beginning the examination. This increases the overall quality and effectiveness of exams.

North Carolina examiners, for example, analyze monthly financials and follow up with visitations and/or inquiries to their banks. The Massachusetts Division of Banking has pre-examination procedures in place to ensure that the scope of each examination is tailored to the institution and will capture the areas or functions that are determined to pose the highest level of risk. Examination teams, particularly the Examiners in Charge, use the information gathered offsite to assess the bank's risk profile and note any developments since the previous examination. Michigan's Banking Department has established a new unit that reviews the activities of a financial institution as a whole - across its business lines- and apprises various specialists.

Twenty-five states now allow their state-chartered banks to incorporate as limited partnerships and subchapter S corporations for state tax purposes. This provides additional flexibility for institutions that seek an organizational structure other than a traditional corporation.

Authorizing mobile branches is another step states have taken to improve flexibility and create opportunities for banks to serve a broad range of communities. Forty-one state banking departments now allow these facilities, which especially help l rural and low-to-moderate income areas.

I do not mean to suggest, by citing these examples, that all fifty states will or should enact these provisions. One of the dual banking system's chief virtues is that it permits innovation and experimentation at a more local level. New ideas can thus be tested and refined in one or several states before they are adopted nationwide.

Many states have focused their attention on making bank regulation more efficient, and have implemented a "best practices" strategy toward regulation. And, of course, all states have worked hard to keep examination fees and supervisory assessments low for their banks.

Coordinating to Reduce Burden in an Interstate Environment

Coordination and cooperation have been hallmarks of state bank supervision since the early 1990s. CSBS strongly believes that a system of multiple regulators can actually reduce regulatory burden by preventing a financial regulatory oligarchy. To accomplish this, however, all regulators must coordinate and cooperate in supervising any one institution.

The state banking departments have done much to reduce regulatory burden not just individually, but as a system. With Riegle-Neal's enactment in 1994, CSBS formed, with the FDIC and the Federal Reserve System, the State-Federal Working Group. The working group's goal is to minimize conflicts and duplication among the state and federal bank regulators in supervising interstate state-chartered banks.

Separately and through the State-Federal Working Group, the state banking departments developed two agreements: the Nationwide Cooperative Agreement, signed by all 54 state banking departments, and the Nationwide State/Federal Supervisory Agreement, signed by the states, the FDIC and the Federal Reserve. Signed in November 1996, the Nationwide Agreements – unanimously agreed to by the state banking departments, the Federal Reserve and the FDIC – were the culmination of two years of work toward a system of "seamless supervision" for the interstate operations of state-chartered banks. The agreements serve as a model for cooperation and coordination between the states and the federal regulators.

The agreements provide a single regulatory point of contact for state-chartered banks that branch across state lines. Federal and state regulators have each designated a single point of contact for the overall supervision of a multi-state bank. Most recently, the Working Group produced a single uniform application for interstate branching. To date, over two-thirds of the states have adopted this form, and more are considering its adoption.

Our coordination efforts benefit all financial institutions operating in the United States, not just domestic banks. Through a CSBS-led effort, state and federal bank regulators signed agreements in 1998 to create a streamlined system for the supervision of U.S. offices of foreign banks across state lines. These agreements, signed by the states, the Federal Reserve and the FDIC, are modeled after the domestic agreements for interstate supervision.

These agreements seek to improve coordination and cooperation in the supervision of the multi-state operations of foreign banking organizations that operate under a state license or charter. They provide for a seamless supervisory process with minimal regulatory burden, and ensure that supervision is flexible and commensurate with the bank's structure and risk profile.

Looking beyond depository institutions, we realize that providing trust services has increasingly become an interstate business. The states have adapted by developing a model form states can use for processing requests for state-chartered institutions to operate on a multistate basis.

At the state level, to further this necessary cooperation and coordination, we have formed joint task forces with the National Association of Insurance Commissioners (NAIC), the North American Securities Administrators Association (NASAA). The purpose of these task forces is to share information and, where appropriate, to coordinate supervision toward our mutual goal: a wide range of safe, responsible, accessible financial services for our states' citizens.

To facilitate this coordination, regulators representing the Conference of State Bank Supervisors (CSBS) and the National Association of Insurance Commissioners (NAIC) jointly developed a model agreement to improve the coordinated supervision and regulation of banks engaged in insurance sales.

This effort has helped supervisors avoid imposing regulatory burdens, such as making redundant requests for information or failing to coordinate responses to consumer complaints. Coordination in these areas should benefit banks engaged in insurance sales and lead to more efficient, streamlined supervision.

Efforts such as these recognize that while the differences in law allowed by our dual banking system often produce innovation, some differences can inhibit the competitiveness of our financial institutions. We are committed, as a state system, to fostering diversity while working toward certain consistent goals. We recognize that we must encourage a broad range of opportunity, while giving financial institutions a degree of certainty and consistency so that they can serve their customers effectively across state lines. This is the true value of the state charter – it is a charter of choices.

Role of Technology

State banking agencies also use technology to reduce regulatory burden. Individual states have been able to streamline their regulatory procedures through technological enhancements. In my own state, Idaho, we now accept all forms and applications online and also allow financial institutions and licensees to pay their fees online. A number of other states have made similar advances. Illinois will soon be the first state banking department to cross-certify its public-key infrastructure with the federal government's Federal Bridge Certification Authority. Other states have instituted other technological conveniences, such as ACH transactions for assessment payments. Some allow online access via the Internet for institutions to view and maintain their own information, such as addresses, key officer changes, and branch and subsidiary office locations.

Seven state banking agencies **--** Alaska, Florida, Georgia, Maine, Minnesota, Nebraska and Tennessee **--** allow banks to file applications electronically, such as through the Department's website. **Thirty-four** states have adopted an interagency federal application that allows would-be bankers to apply simultaneously for a state or national bank or thrift charter and for federal deposit insurance. The state banking agencies worked through CSBS with the federal banking departments to draft a uniform, consistent application for the industry.

Through the use of shared technology, state and federal banking agencies work together continuously to improve the quality of the examination process, while making the examination process less intrusive for financial institutions.

Through CSBS, the state banking departments have played a pivotal role in coordinating efforts with the federal regulators to develop and improve several automated examination tools that will strengthen the examination process and facilitate more efficient, risk-focused, quality examinations. Our goals are to make the time examiners spend in the institution more productive, and to expedite the entire examination process, thus freeing bank management to devote their efforts to the business of banking.

"FINANCIAL SERVICES REGULATORY RELIEF ACT OF 2003"

We would like to thank the Committee for considering our views on the "Financial Services Regulatory Relief Act of 2003."

Interstate Branching

Current Federal law takes an inconsistent approach toward how banks may branch across state lines. While Riegle-Neal gave the appearance that states could control how banks could enter and branch within their borders, this has not always been the reality.

Perhaps because many believed that the Federal thrift charter would be eliminated at the time Riegle-Neal was adopted, the law was not applied to federally-chartered thrifts. The result is that a Federal thrift can branch without regard to state law and rules of entry.

Since the passage of Riegle-Neal, the Office of the Comptroller of the Currency has promulgated creative interpretations of the National Bank Act that effectively circumvent the application of Riegle-Neal to "branch-like" operations. CSBS has unsuccessfully opposed these interpretations in comment letters and as a friend of the court on several occasions.

These interpretations have placed state-chartered institutions, particularly community banks in multistate markets, at a competitive disadvantage to those larger, federally-chartered institutions that can branch without restriction.

States have had to address this disadvantage by changing the laws being circumvented. Since the passage of Riegle-Neal, a number of states have moved to allow *de novo* branching. Seventeen states now allow *de novo* branching, most on a reciprocal basis. In December 2001, the CSBS Board of Directors approved policy to encourage all states to consider enacting *de novo* branching laws.

We appreciate your revisiting the Riegle-Neal Act, and we urge Congress to eliminate the disadvantage it has created for state banks because of inconsistent application of Federal law. We are especially glad that your review included language that addresses the disadvantage for state trust operations created by OCC and OTS interpretations.

Other Suggestions

State Member Bank Parallel Treatment

In particular, CSBS encourages you to grant the Federal Reserve more flexibility to allow state member banks to engage in investment activities authorized by their chartering state and approved by the FDIC as posing no significant risk to the deposit insurance fund.

This amendment would remove a provision in the Federal Reserve Act that places unnecessary limitations on the powers of a state member bank, limiting state member banks to the activities allowed for national banks. As state-chartered nonmember banks have always been allowed to exercise expanded powers – within the confines of safety and soundness – it is an appropriate regulatory relief effort to eliminate this prejudicial and unnecessary distinction between state-chartered member banks and state-chartered nonmember banks. This provision does away with this arcane restriction, which has no basis in promoting safety and soundness.

As you know, Congress has consistently reaffirmed the states' ability to craft banking charters to fit their economic needs and experiment with new products and services. Congress once again reaffirmed this authority in 1991, when FDICIA allowed states to continue to authorize powers beyond those of national banks.

An empowered state banking system is essential to the evolution of our banking system and elemental to state economic development. This change would help to advance that goal.

Limited Liability Corporations

The states and CSBS have a long history of advocating and facilitating innovations within the banking industry, including organizational structures available to state-chartered banks. In that regard, CSBS has strongly supported an FDIC proposal to make federal deposit insurance available to state chartered banks that organize as limited liability companies (LLC). An LLC is a business entity that combines the limited liability of a corporation with the pass-through tax treatment of a partnership. Through a proposal released for public comment last summer and recently finalized, the FDIC has determined that state banks organized as LLCs are eligible for federal deposit insurance if they meet established criteria designed to insure safety and soundness and limit risk to the deposit insurance fund.

Only a small number of states now allow state-chartered banks to organize as LLCs, including Maine, Nevada, Texas and Vermont. Discussions with state banking agencies, however, indicate that several states may consider this option in the future. State banking departments and bankers alike are interested in the LLC operational structure because LLCs offer the same tax advantage (pass-through tax treatment) as Subchapter S corporations, with greater flexibility. LLCs, for example, are not subject to the limits on the number and type of shareholders that apply to a Subchapter S corporation. It remains an open question, however, whether pass-through taxation status for federal income tax purposes will be available to state banks organized as LLCs. An Internal Revenue Service regulation currently blocks pass-through tax treatment for state-chartered banks. Despite this prohibition, there are reportedly state tax advantages.

We ask the Committee to work with the Ways and Means Committee to encourage the IRS to rethink its interpretation of the tax treatment of state-chartered ILCs.

During this time when all corporations, including banks, find themselves under increased scrutiny for sound operating procedures, robust corporate governance standards, and ethical business practices, banks organized as LLCs are subject to no less regulatory scrutiny or operating requirements than traditional banks. In fact, the full range of requirements that apply to banks organized as traditional corporations, including enforcement and supervisory authority in the Federal Deposit Insurance Act, applies to LLCs. State banks organized as LLCs must also meet all of the safety and soundness related requirements of the state banking agency that charters the institution.

Federal Financial Institutions Examination Council

Improved coordination and communications between regulators clearly benefits bankers and reduces regulatory burden. In that spirit, we suggest that Congress could improve the Federal Financial Institutions Examination Council (FFIEC) by changing the state position from one of observer to that of full voting member. State bank supervisors are the chartering authorities for nearly seventy percent of the banking industry, and are thus vitally concerned with changes in regulatory policy and procedures.

Review of Regulatory Preemption

We also ask the Committee and the Congress to address the implementation and implications of regulatory preemption by the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

The OTS currently does not publish its preemptive decisions because of the agency's interpretation of the Home Owners' Loan Act, and because Congress has not applied the guidelines for preemption articulated in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 to the OTS.

The banking system would benefit greatly from a more open dialogue between the federal government and the states about applicable law for federally chartered financial institutions.

The states are increasingly concerned about the growing boldness of OCC and OTS preemption. The OCC has asserted that it is only interpreting the National Bank Act in its preemptions, and is merely reflecting congressional intent. The OTS makes similar claims. CSBS respectfully disagrees. We believe that regulatory interpretations have moved away from well-considered public policy into the realm of loophole –lawyering. It is one thing for the Congress to openly and publicly debate policy and establish federal standards. It is quite another when a regulator proposes cleverly worded interpretations that a clear reading of the law would not support. The Congress has a role in reviewing the growing expanse of state consumer protection laws being preempted for national banks, federal thrifts and now their subsidiaries.

CSBS believes this request for review of preemption and applicable law is appropriately a regulatory burden reduction matter. Our banking system – particularly for state-chartered institutions – is a complex and evolving web of state and federal law. Greater sunshine on OCC and OTS interpretations of applicable law for the institutions they charter would also help clarify applicable law for our nation's over 6,000 state-chartered banks.
A clearer articulation of OCC and OTS standards of preemption would also lessen the legal burden of litigation over the federal regulators' sometimes tenuous interpretations of applicable law.

We need a banking system that both acknowledges the needs of multistate banks and financial services firms and protects consumers. Given that consumer needs can vary considerably across our nation, and that the states are closer to their citizens, we believe that consumer protection is often best addressed at the state level. CSBS is committed to working with the Congress to address the needs of an evolving nationwide financial services system in a way that respects the interests of all our nation's financial services providers and minimizes regulatory burden, while also protecting our nation's consumers.

Conclusion

The quest to streamline the regulatory process while preserving the safety and soundness of our nation's financial system is critical to our economic well-being and to the health of our nation's financial institutions. Like you, and like our federal agency counterparts, we at the state level are constantly balancing the public benefits of regulatory actions against their direct and indirect costs. Our most important guide is the fundamental principle of safety and soundness.

We commend this Committee for its efforts in this area. State bank supervisors appreciate the Committee's interest in eliminating barriers in federal law to innovation from the state charter. We thank you for this opportunity to testify on this very important subject, and look forward to any questions you and the members of the Subcommittee might have.